Stress free country monitoring:

Italy

The ADA team

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Forecasts

	2009	2010	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Real GDP	-5.5	1.6	0.7	-2.9	-1.7	0.2	0.9	1.1	1.5	1.6	1.8
Nominal GDP, trn	1.574	1.605	1.638	1.613	1.605	1.622	1.645	1.673	1.723	1.783	1.854
HICP, avg	1.1	2.1	3.7	2.6	0.6	0.0	0.1	0.5	1.5	1.8	2.3
Unemployment rate eop	8.5	8.6	9.5	11.6	12.6	13.3	11.9	12.2	10.8	9.5	8.5
Budget deficit % of GDP	-5.3	-4.2	-3.7	-2.9	-2.9	-3.0	-2.7	-2.4	-2.3	-2.1	-1.9
Debt % of GDP	112.5	115.4	116.5	123.4	129.0	131.8	132.1	132.6	131.3	129.2	126.2

Sources: Eurostat data, ADA Economics

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Italy: A recap of the past month

Economy: export and business confidence data have surprised to the upside and consumer confidence improved. Hiring intentions are up, suggesting a slow but continuing drop in the unemployment rate. Actual job creation remains small, in our view, and high hiring appetite is masking a gradual repricing of labour towards more flexibility and lower wages. Borrowing costs are rising, but remain low by historical comparison. Real GDP growth, in our view, is cruising at 1.5% yoy, with upside risks.

Inflation surprised mildly to the downside in September, and should continue to trend around 1.4% yoy for the rest of the year, accelerating to 1.8% next year.

Electoral law: a new electoral law (Rosatellum) has been approved by the lower house in October and is now awaiting Senate approval. The new system allocates one-third of parliamentary seats via a majoritarian system and the remainder in a proportional system, which implies that it structurally supports the centre-right coalition. Currently a centre-right government or a coalition led by M5 are the two most likely outcomes from the 2018 elections, however beware that the poll date is far and plenty of shocks may happen before then.

What caught our eye in politics

Berlusconi has stated to the press that, if the centre-right coalition does not win, he will leave politics.

Former PM Renzi has come under pressure from various members of his party and smaller centre-left parties for putting forward an electoral law that does not give any special edge to PD. He also refused to call for primaries to nominate the Prime Minister candidate. In our view, it is not out of question that Renzi may be forced to leave the leadership of PD in favour of a less "controversial" candidate.

M5 has appointed the young Luigi Di Maio as its Prime Minister candidate. In our view, this is a risky choice for the party as di Maio is inexperienced and may end up like Rome mayor Raggi who in the end had enormous problems in putting together and retaining experienced professionals in her cabin

Italy: Key factors to watch

<u>Finalisation of the budget</u>: the government has put forward its budget proposal, which will now need to be approved by parliament by the year-end.

<u>The flash estimate for 3Q GDP</u> will be released on 14 November, we expect to see a pick-up to 1.6% yoy, from 1.5% in 2Q.

<u>Referendum:</u> an independence referendum for Lombardy and Veneto will take place on 22nd October in those two regions. The question posed to voters is whether they want to start the legislative process to seek greater autonomy similar to the already existing five regions with special status within the framework described by the Constitution (art116) <u>and consistent with the unity of the Italian Republic</u>. This is a policy that was put forward by the Northern League years ago, so a strong YES response is likely to add credibility in the eyes of the electorate, especially among those that may be considering switching their support out of 5 Stars & Forza Italy towards the Northern League. The opinion polls show the share in favour of independence as high as 92-94%, but it is unclear whether the turnout will breach 50% of residents.

<u>The final vote on the electoral law</u> is expected by November, although another verdict by the Constitutional Court may be announced in January.

2018 Budget highlights

- The government recently approved the 2018 Budget layout, which aims to continue to consolidate the budget deficit, but it also tries to distribute a few resources to improve competitiveness and reduce social tension. The Budget will spend about two months in parliament and usually reaches final approval just before Christmas.

- The general government deficit target is set at 1.6% of GDP from next year, while we forecast a shortfall of 2.4% this year with a minor consolidation in 2018.

- The underlying assumptions appear very reasonable to us – in fact, more so than in the past. The key supportive factor this time around is that inflation is rising, which helps to increase budget revenues. We see real GDP growth at 1.5% or higher in the next few years (barring any major global slowdown).

The positives of this budget

- There is a slow, but hopefully steady, plan to increase public investment for the first time since 2009.

- The combination of a still fairly constrained fiscal stance and rising nominal GDP implies that the debt to GDP ratio WILL ACTUALLY FALL from this year onwards.

- The government has concentrated its efforts in fiscal incentives towards employment, investment and social support, including public sector workers.
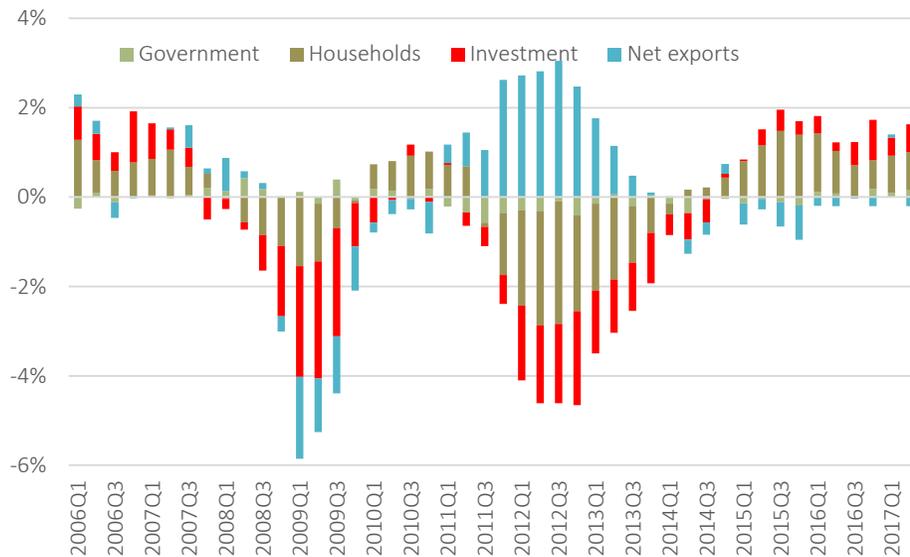
The limitations of this budget

- While it supports the cyclical recovery, potential GDP growth for now is stuck at zero and the process of improvement is slow, in our view, and constrained by the very small budget adjustments each year.
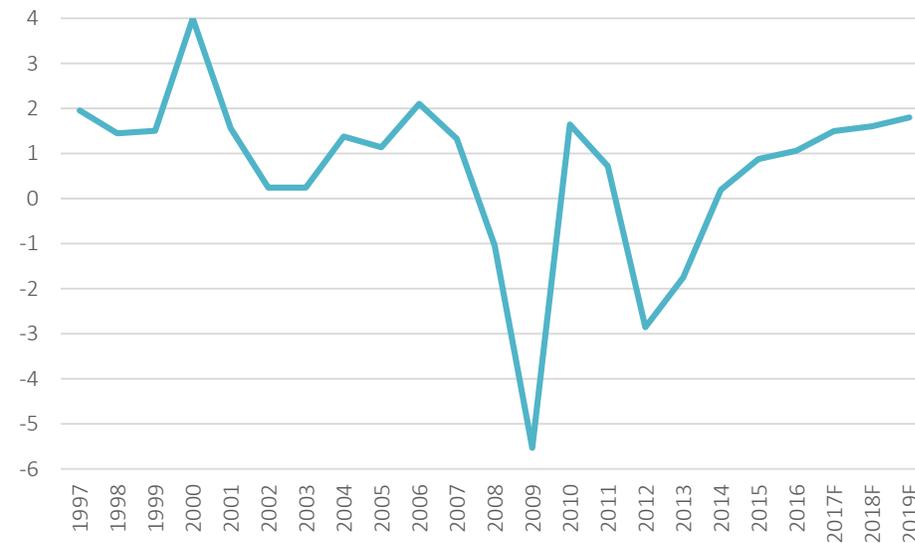
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Macroeconomic backdrop
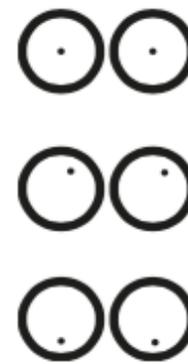
GDP growth and projections

Contributions by key component to YoY growth

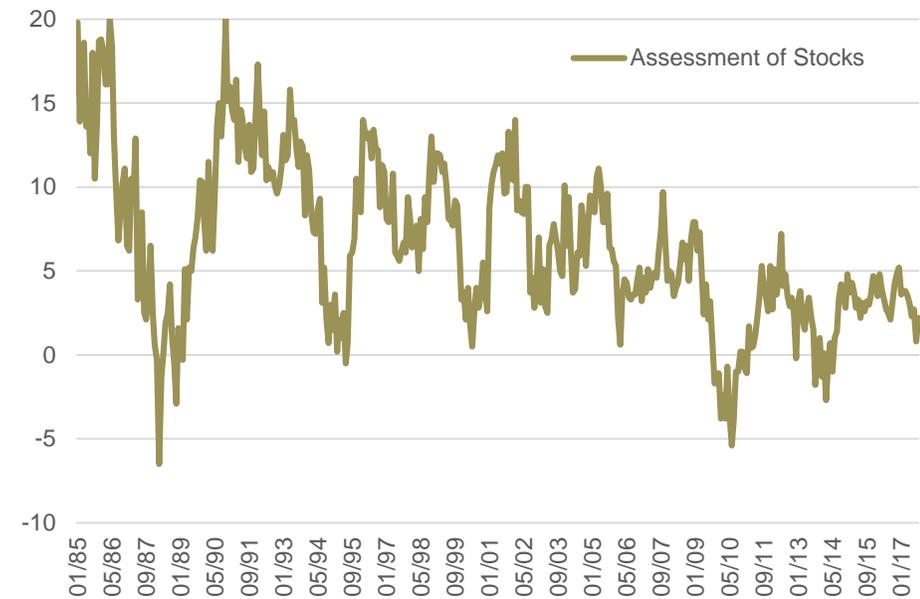Outlook for the next two years

Sources: Macrobond, ADA Economics

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Industrial sector

Industrial sentiment (RHS) and pricing power recovering

Inventories are relatively low

- Industrial production in coming months should be supported by improving demand, relatively low inventories and recovering pricing power (though still low in historical perspective)
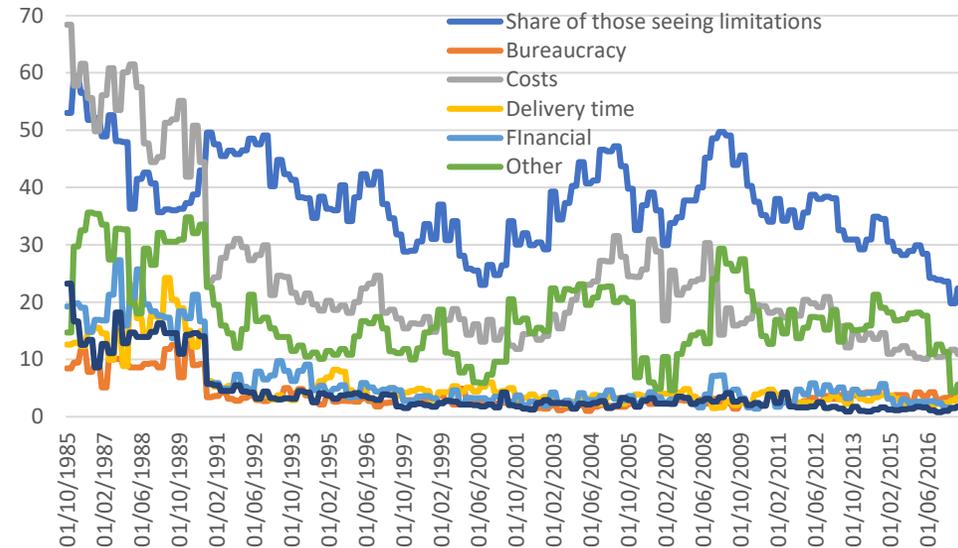
Sources: Macrobond, CEIC, ADA Economics

Industrial sector

Manufacturing sector capacity utilization

Factors limiting exports production

- Capacity constraints are rising, which should help with a modest recovery of investments. Companies that report limitations to exports are few in historical perspective and financial constrains are no longer an issue.

Sources: CEIC, ADA Economics

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Industrial sector

Competitiveness perceived domestically & abroad
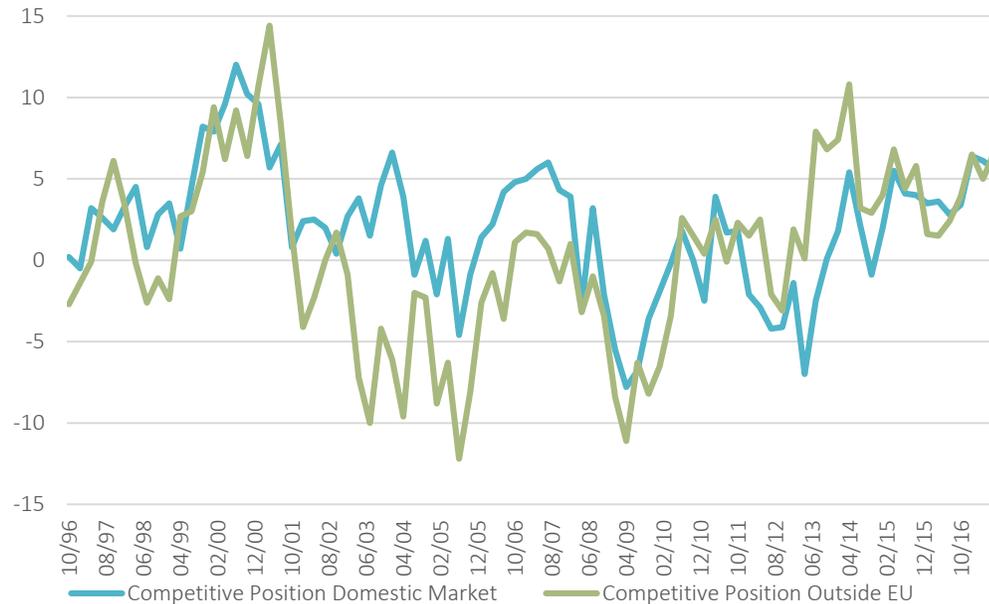
Months of secured production

- Surveys reporting companies' perceived competitive position signal a steady improvement in recent years and a jump in the number of secured months of production, which in other countries has proved to be a key leading indicator of the turnaround in the recovery

Sources: CEIC, ADA Economics

Industrial sector

Top performing manufacturing sectors (yoy)
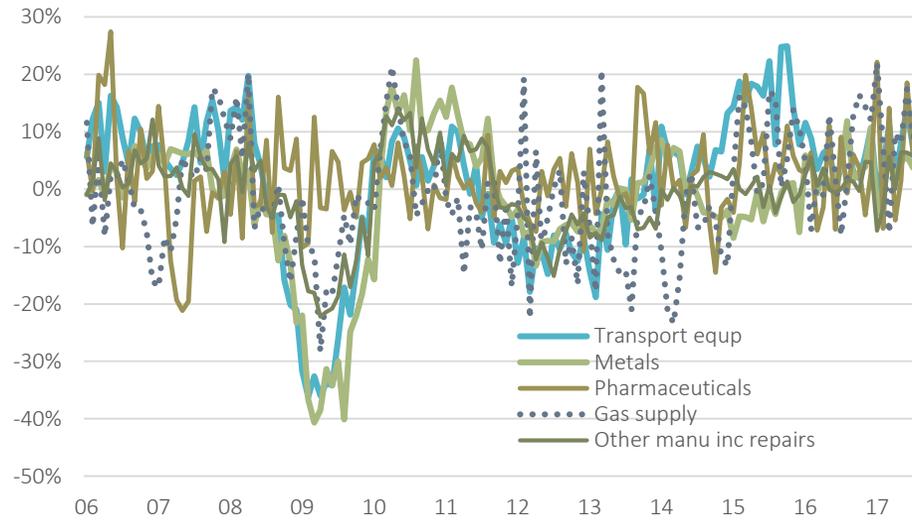
Manufacturing: worst performing sectors (yoy)

Sources: Macrobond, ADA Economics
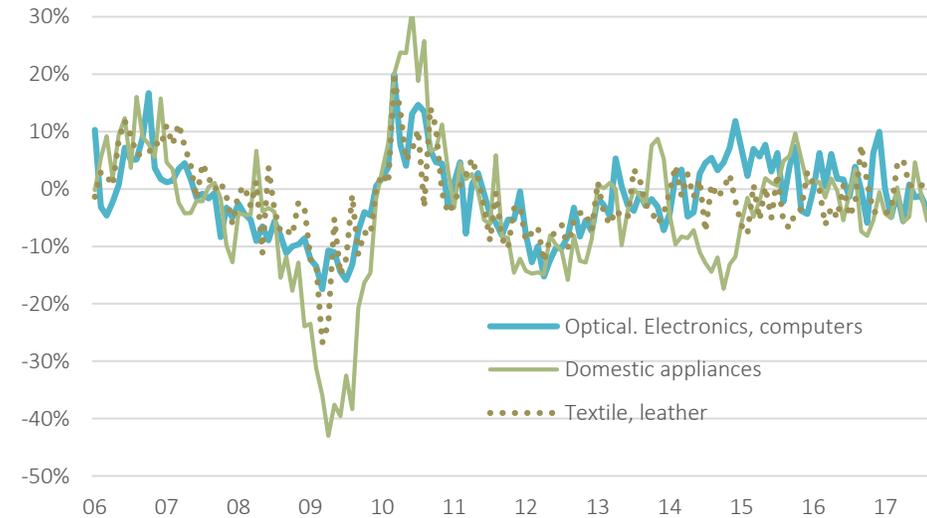
NFCs' balance sheets have improved

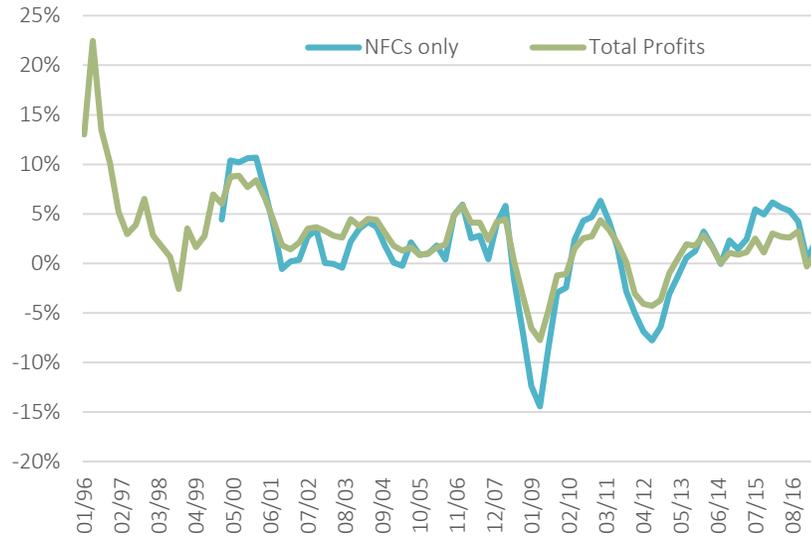Debt-to-GDP ratio
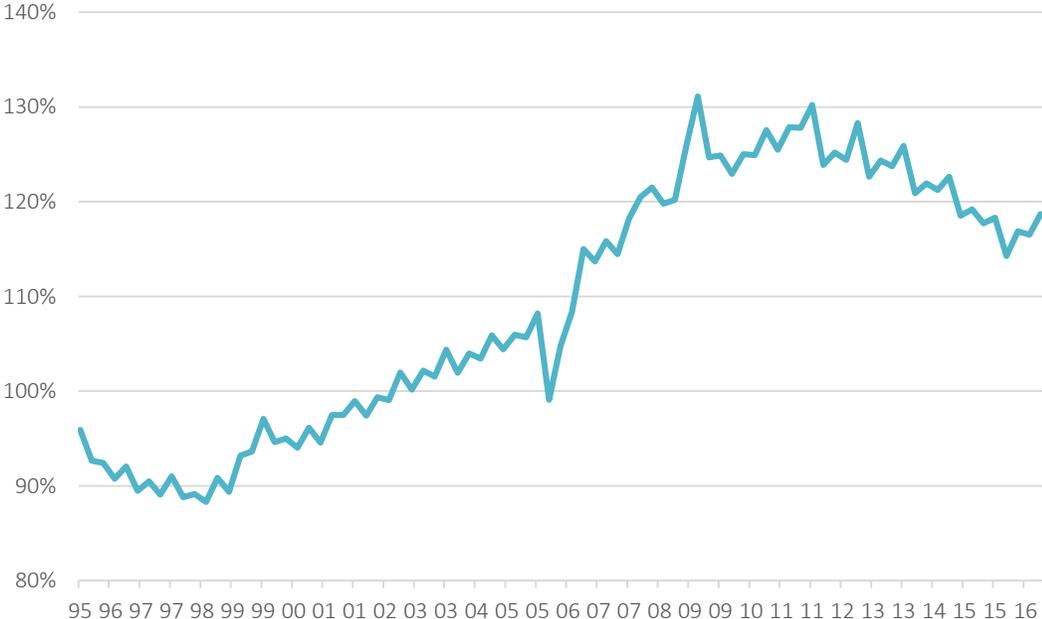
Assets-to-GDP ratio
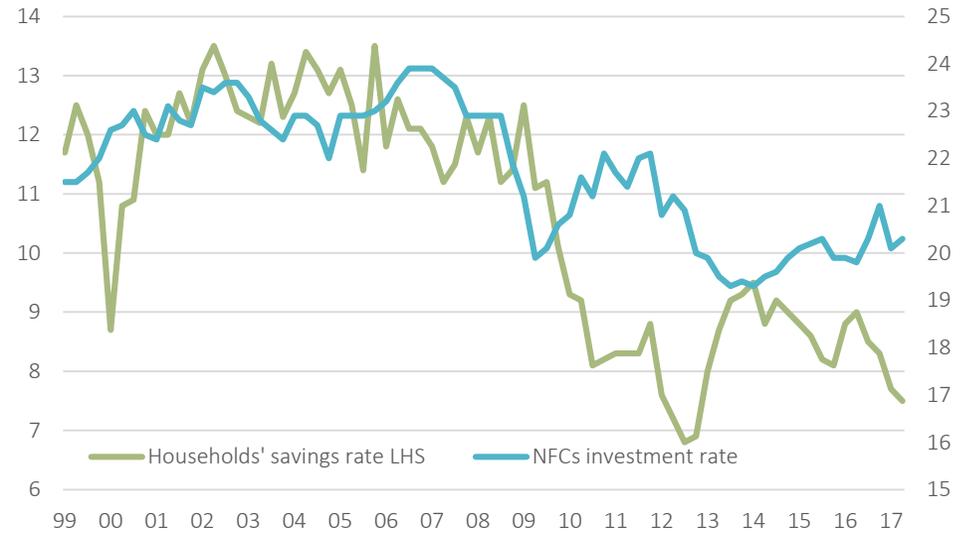

Sources: Macrobond, ADA Economics

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Profitability: better but not stellar

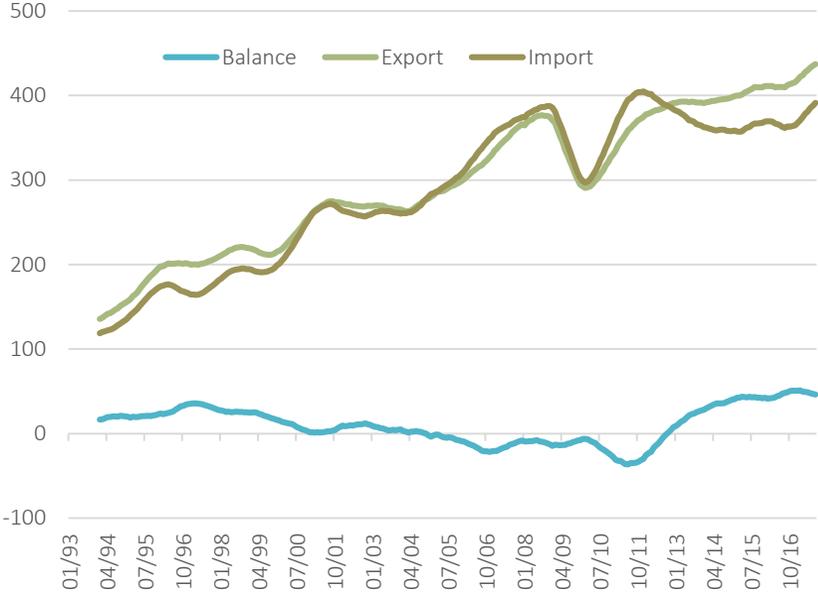Profits are rising, but not that fast...

...but the investment rate is improving, while households continue to run down savings

Sources: Macrobond, Eurostat, ADA Economics

External sector

Exports and imports dynamics (EURbn)
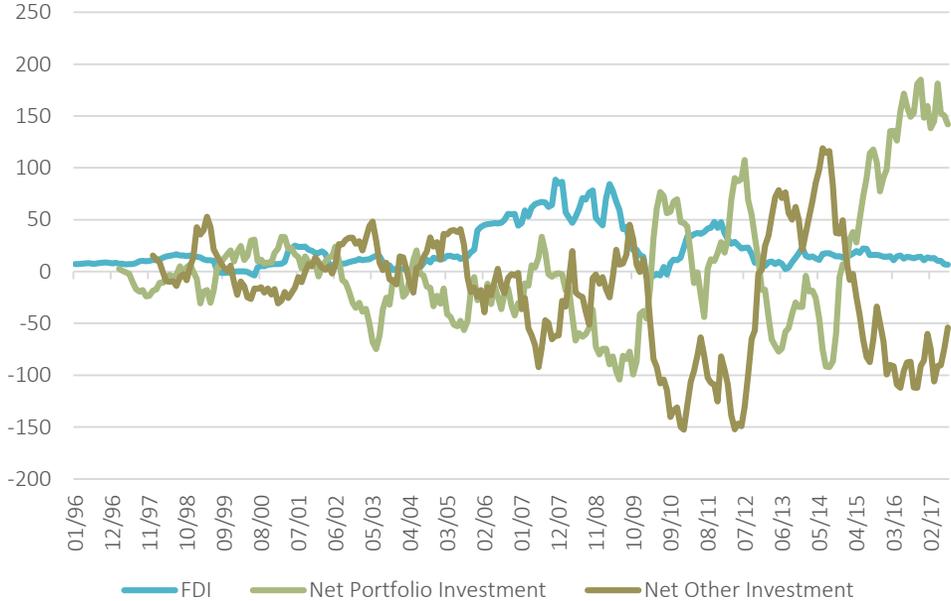

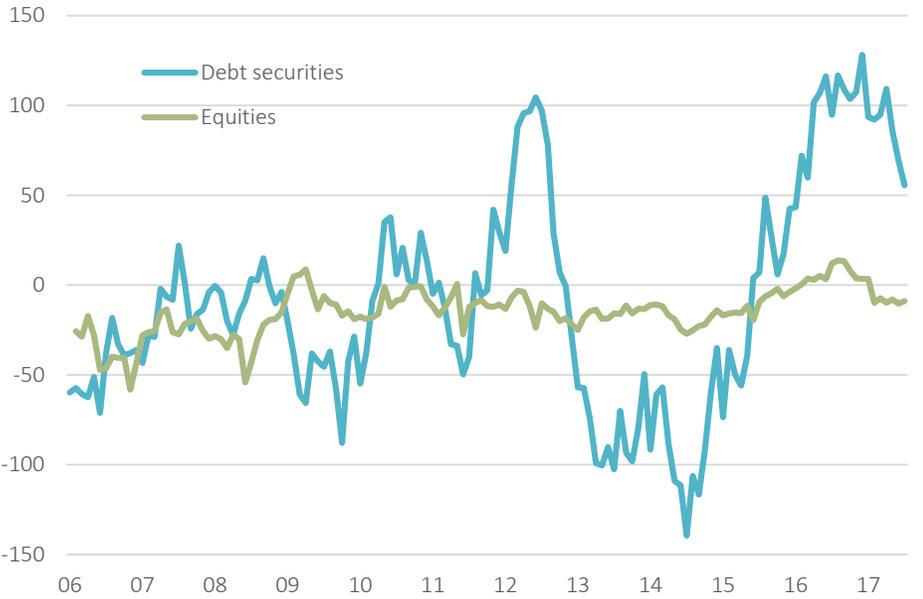Current account breakdown dynamics (EURbn)

External sector

Financing for the current account: large portfolio outflows persist

Net outflows of debt portfolio investment, while there is a

Minor net inflow of portfolio investment in equities

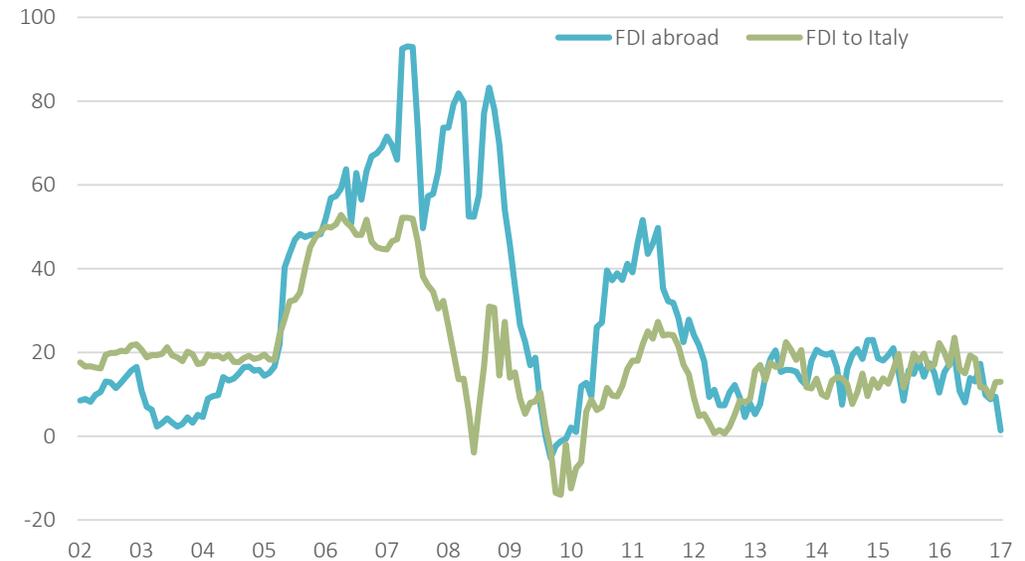Sources: Macrobond, ADA Economics, EUR bn, 12m trailing sums

Voting with their feet: remittances and FDI…

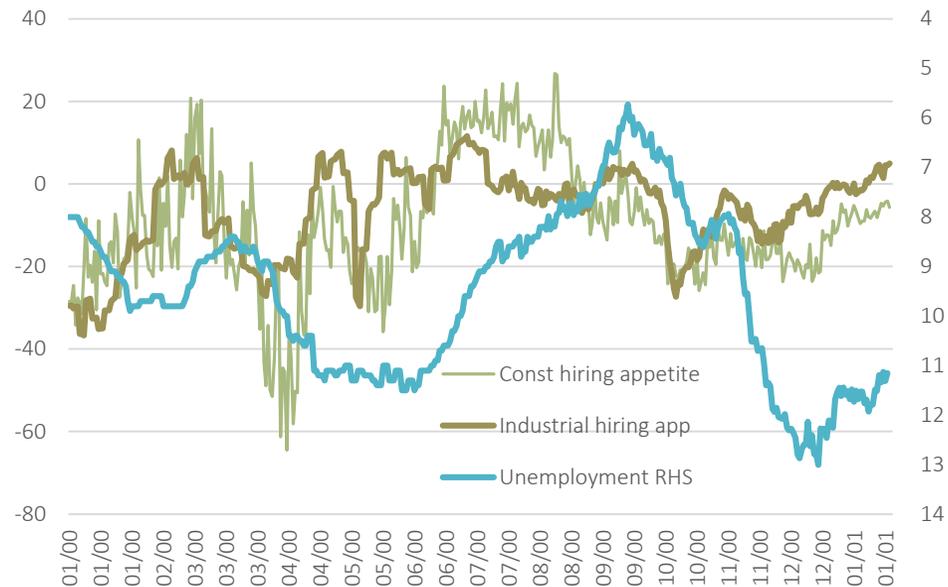Four-quarter rolling sum of remittances, Euro bn

12m rolling sums of FDI flows

Sources: Macrobond, ADA Economics

Labour market

Hiring appetite fairly high in historical perspective, but the unemployment rate is falling slowly

Projected change in the unemployment rate

- The correlation between the unemployment rate and hiring intentions is not as close as in other countries probably because there is churning of labour (switching older/expensive with younger/cheap workforce) and the industrial sector overall is still shrinking, so the survey only picks up the optimism of the well-performing companies

Sources: CEIC, ADA Economics

Labour market: a granular view

Job creation by type of contract (mn of workers)
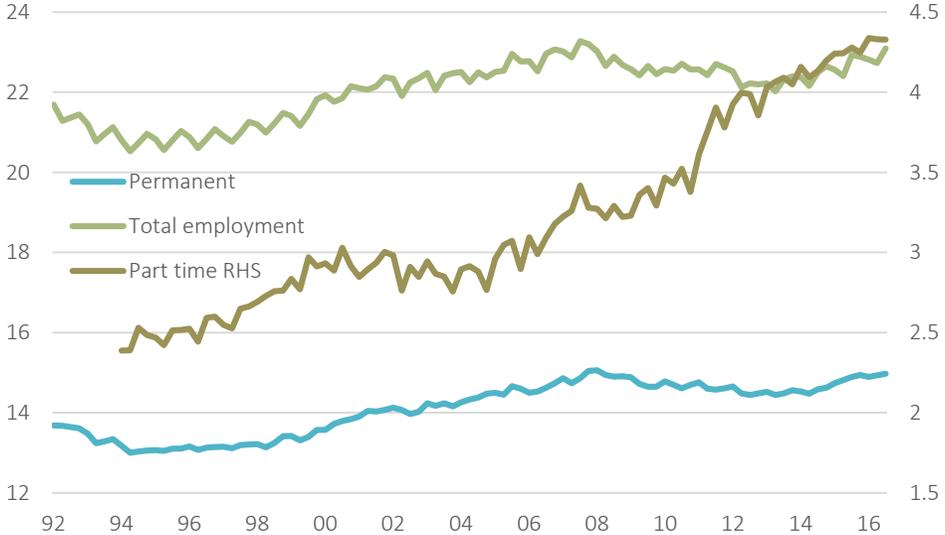
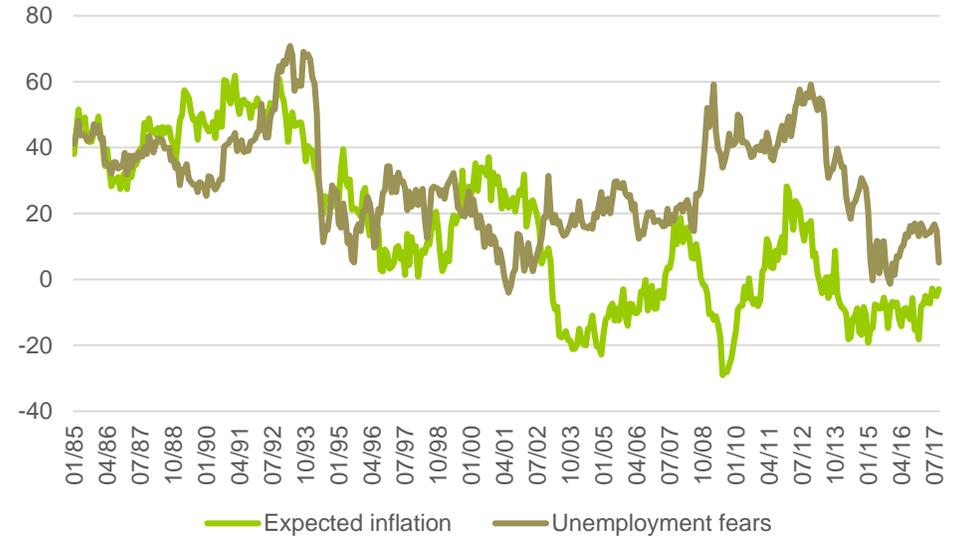Total employment by key sector (mn)

Sources: Macrobond, ADA Economics

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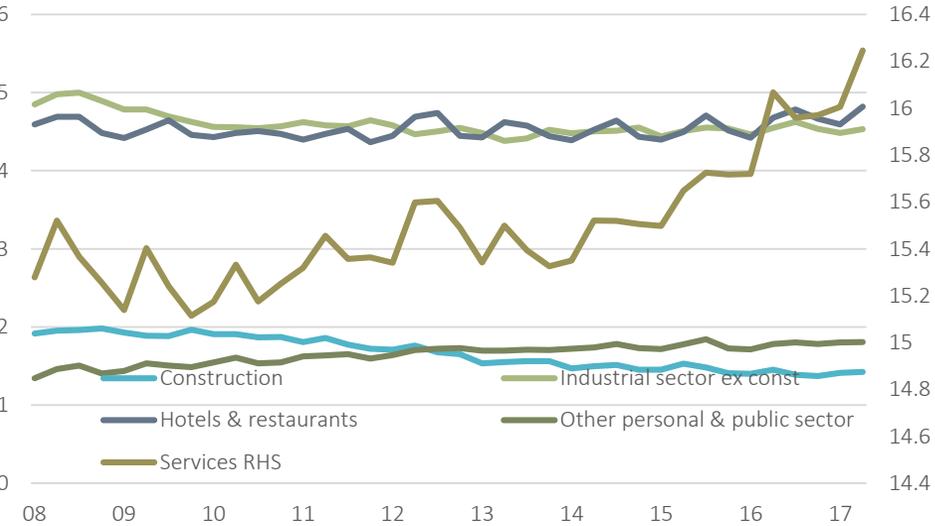
Household sector

Consumer confidence seems to be recovering

...consumers are less worried about prices than unemployment

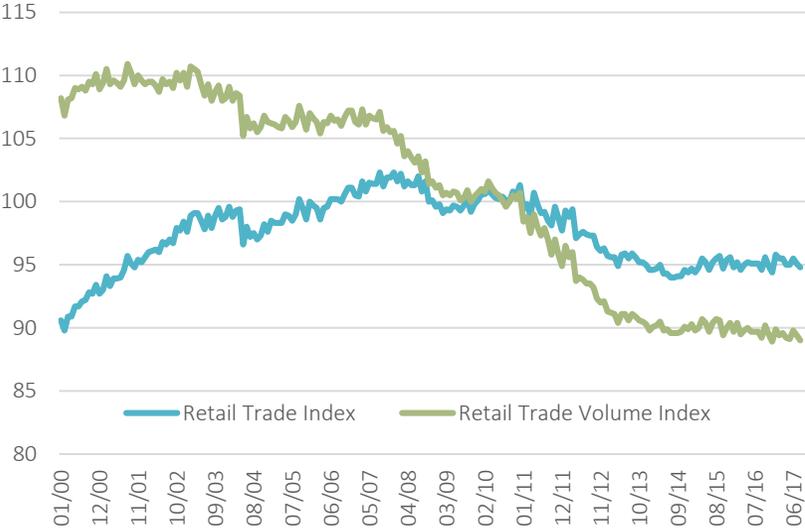Expected inflation   Unemployment fears

Sources: Macrobond, ADA Economics

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Household sector

Borrowing YoY by segment

Retail trade has stabilised in value terms, but volume is still falling)

Sources: CEIC, Macrobond, ADA Economics

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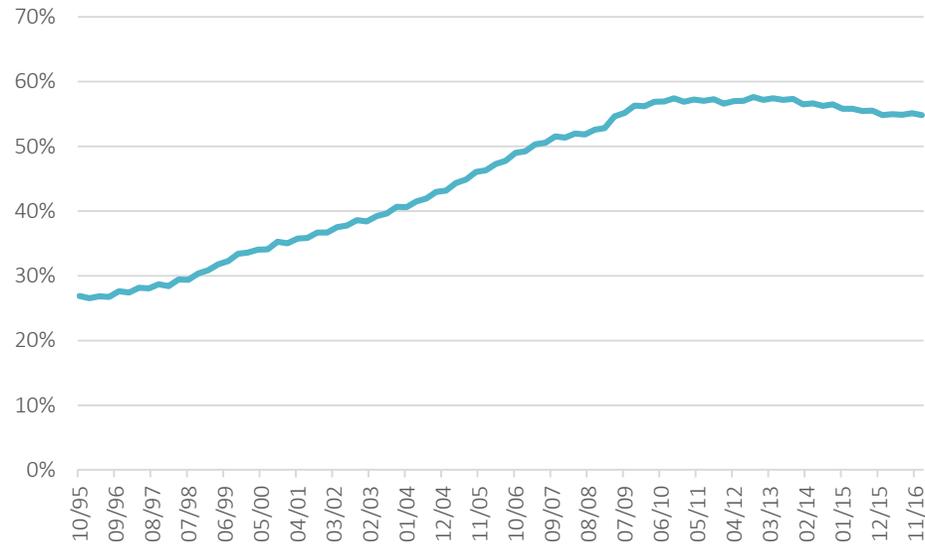
Household sector balance sheet

Debt to GDP

Net financial assets % of GDP

Sources: Macrobond, ADA Economics

Construction sector

Confidence and pricing power are coming back
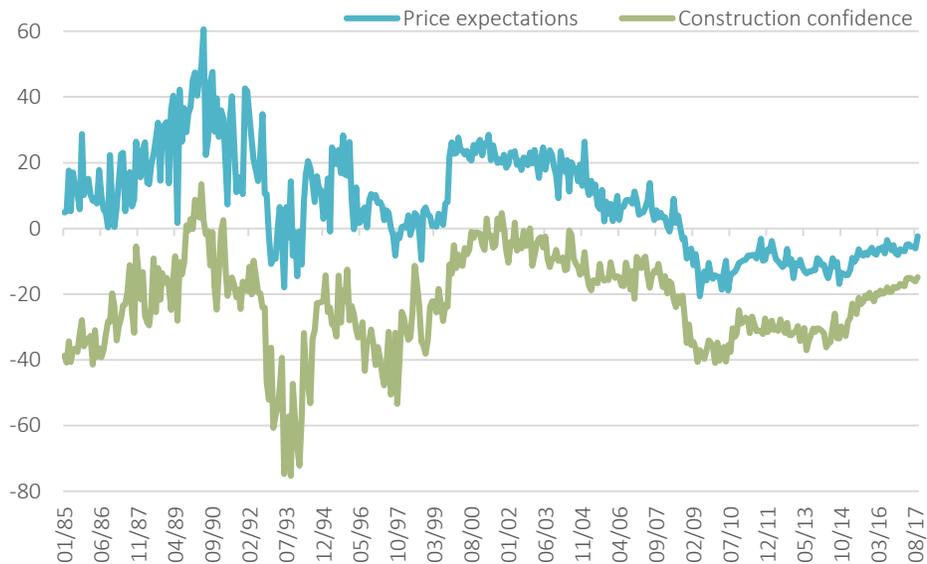
...as well as hiring appetite
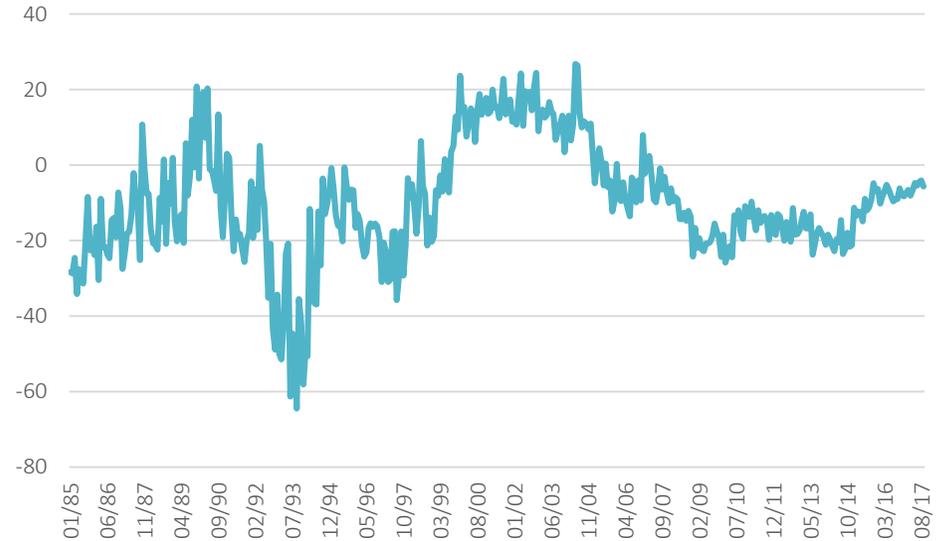
- A sustained recovery of the constructing sector would greatly speed up the drop in the unemployment rate

Sources: Macrobond, ADA Economics

Real estate

Residential and commercial transactions, YOY

YoY changes in Real Estate Prices Index

Sources: Macrobond, ADA Economics

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Banking sector

Deposit and loan YoY growth

Loan to deposit ratio

Sources: Bank of Italy, ADA Economics

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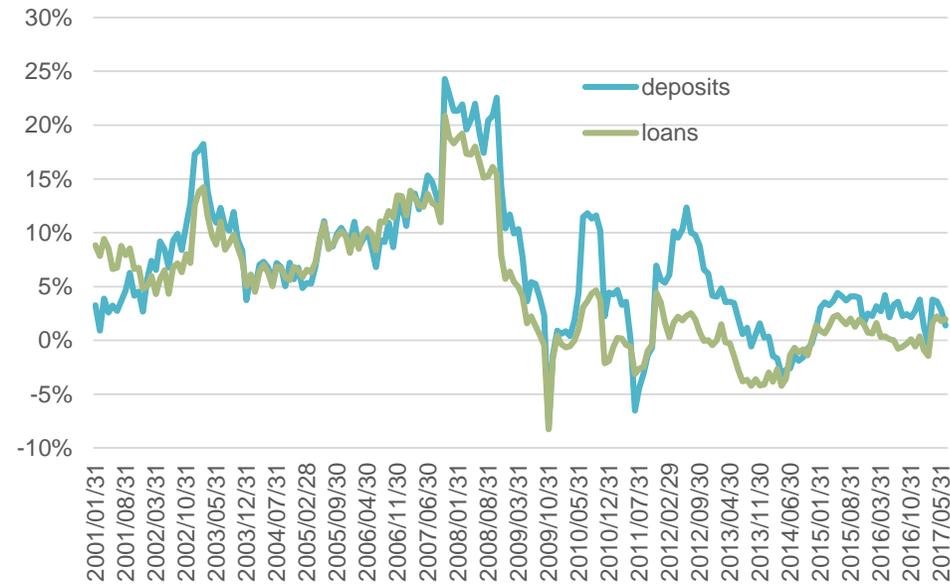
Banking sector

Retail deposit rates, new business
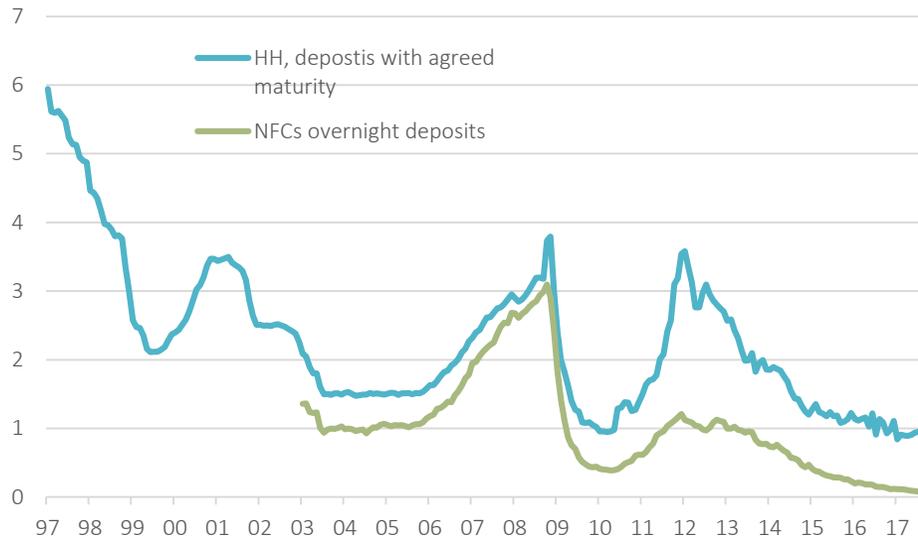
Retail lending rates, new business

Sources: Macrobond, ADA Economics
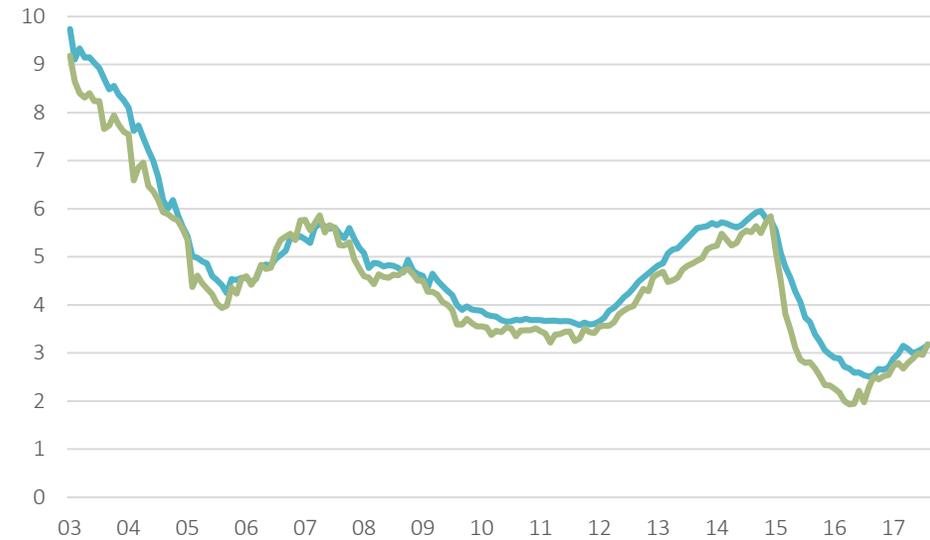
Banking sector

Bonds as a share of total assets

Non-performing loans (EUR bn)

Sources: Bank of Italy, ADA Economics
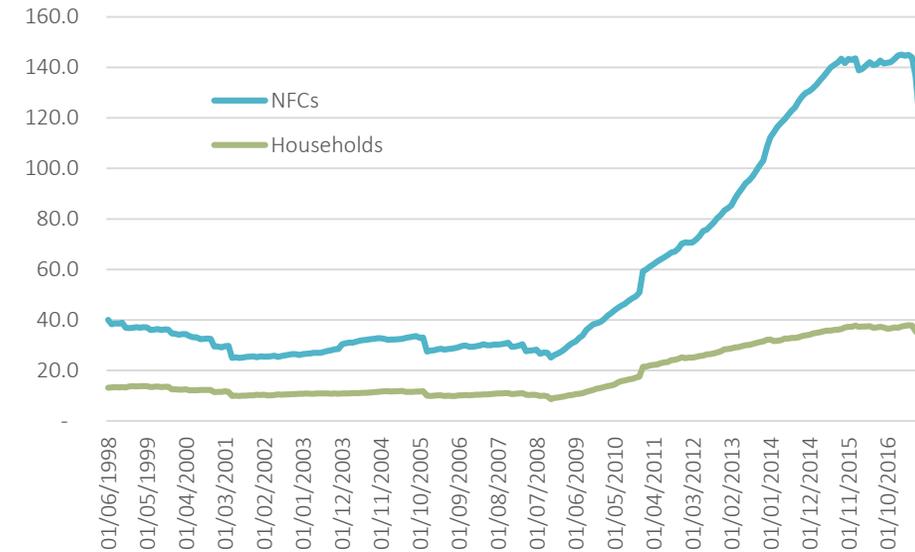
Public sector

2-year sovereign bond yield
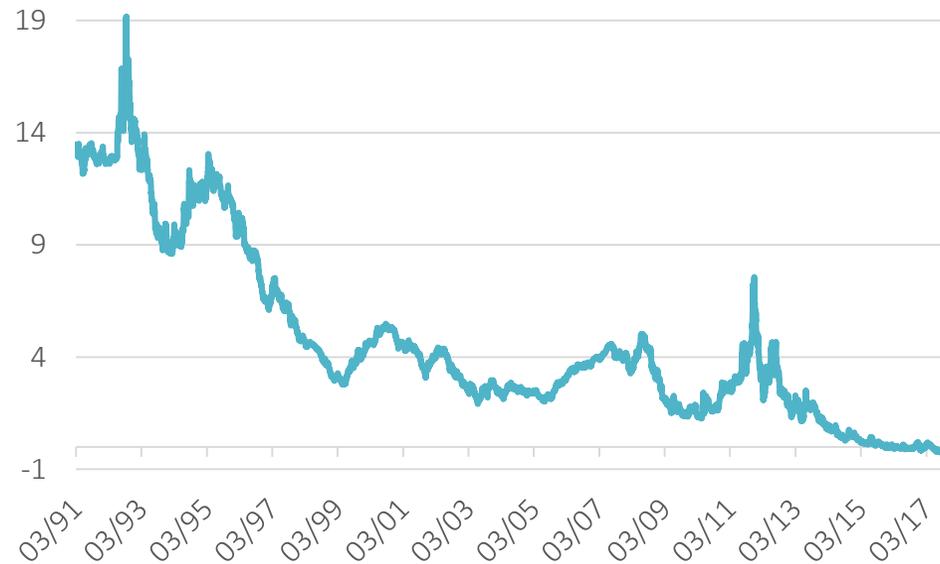
Spread over bund & 15 yr average of the spread

Sources: Macrobond, ADA Economics

Public sector

10 yr sovereign bond yields
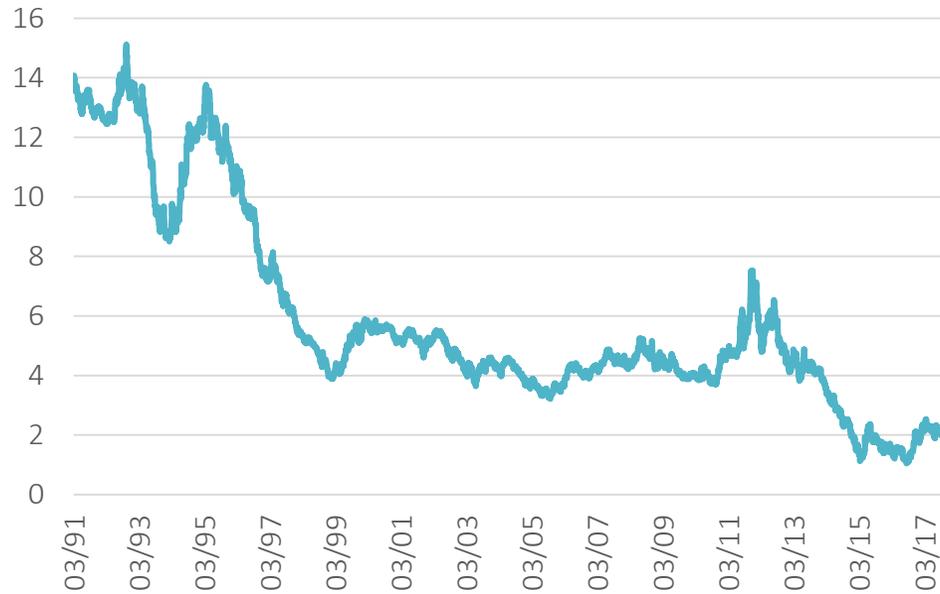
Spread over bunds and 15yr average spread level

Sources: Macrobond, ADA Economics

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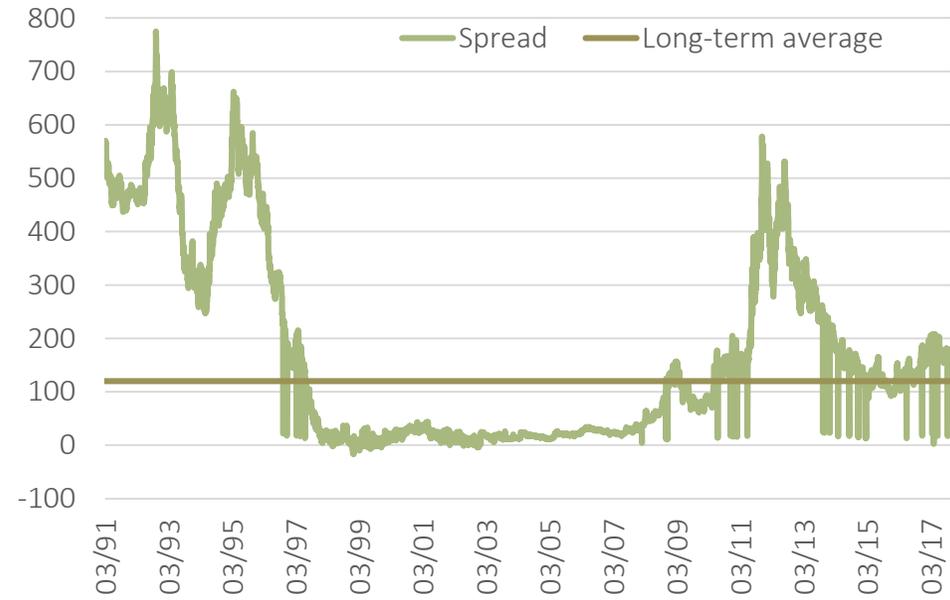
Holdings of bonds

Levels, in billions
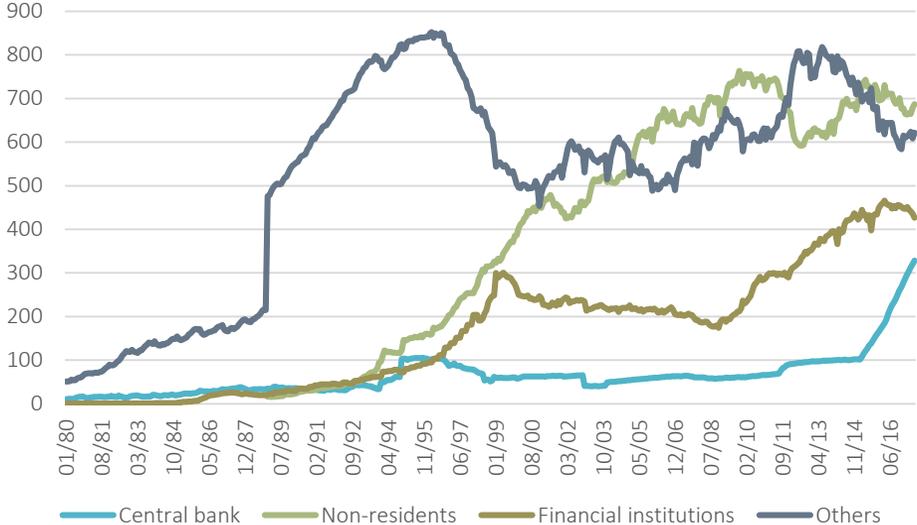
% of total securities

Sources: Macrobond, ADA Economics

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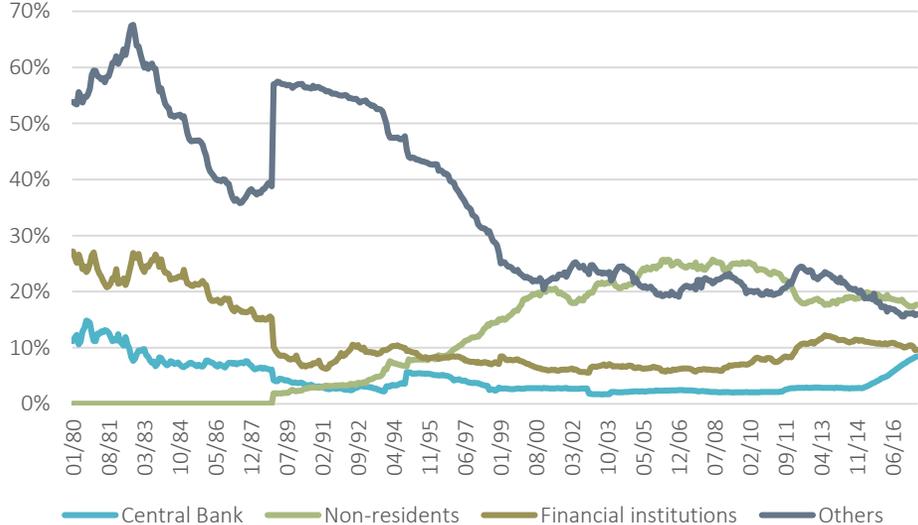
Politics
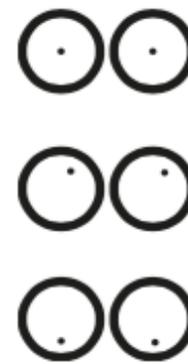
Opinion polls

Current polls for the regional elections in Sicily: M5 35%; centre right coalition 34%, centre left 22%, SI 6%. FdI = Fratelli d'Italia, FI = Forza Italia, NL = Northern League, PD = Partito democratico, SI = Sinistra Italiana

Current polls for the independence referendums: Lombardy YES 94%, Veneto YES 92%

Sources: Macrobond, sondaggipoliticoelettorali.it, ADA economics

Lega Nord (NL)

Leader: Matteo Salvini

Chief economic advisor: Claudio Borghi

Approval rating: Currently 14%, ADA expectation: 20% by election time

Policy programme:

EU reforms, tighter control of labour movements, changes in the labour code (against the Fornero law), stronger emphasis on local territory, eliminating nationwide wage bargaining. Flat tax at 15% for households and companies. Abolishment of the "studi di settore" – which is a system introduced post-2010 to increase tax compliance.

Potential implications:

Lower corporate tax rate to be effective in stimulating growth only if it comes with a thorough restructuring of other tax rules as well.

Elimination of the studi di settore could help keep SMEs in business, but would erode the tax base

Eliminating nationwide wage bargaining would open the door to a drop in wages in the centre and southern part of the country – which may help with competitiveness in the medium term but would also pose risks to mortgage debt servicing costs

Movimento Cinque Stelle (M5)

Leader: Beppe Grillo

Chief economic advisor: No one officially at the moment

Approval rating: Currently 28%, ADA expectation: 25-35% by election time

Policy programme:

Carbon-free Italy by 2050; less hours for work and more work for everybody (Cremaschi model); changing security spending more towards cybersecurity, abolition of subsidies to airports unable to reach financial equilibrium; potentially supportive of the creation of a parallel currency; amendments to Fiscal Compact and monetary union in general. Focus on boosting well being. Amendments to corporate governance laws. Minimum income for all citizens – proposed at around EUR700pm.

Potential implications:

Confusing policy implementation for markets, generally "unfriendly" to large multinationals though not necessarily negative for the growth potential of the economy

Public spending reduction overall

Improved corporate governance rules

Forza Italia (FI)

Leader: Silvio Berlusconi

Chief economic advisor: Antonio Martino

Approval rating: Currently 13%, ADA expectation: 10% by election time

Policy programme:

Flat tax at 24%, increasing social spending for lowest income class and pensioners. Strengthening foreign policy to halt the migrant wave. Supportive of a dual currency system.

Potential implications:

The reduction in the corporate tax rate would boost growth and the industrial base only if it comes with a thorough restructuring of the tax rules

Unclear to what extent the dual currency proposal is genuinely a priority for the party and in any case it appears that not enough work has been done on this issue to have a proper assessment of the impact

Partito Democratico (PD)

Leader: Matteo Renzi

Chief economic advisor: Yoram Gutgeld*

Approval rating: Currently 27%, ADA expectation: at current levels or lower

Policy programme:

Increase public spending on investment and social support. Further reduction in the tax wedge on employment and considering a drop in the corporate tax rate. Strongly in favour of further EU integration. Unclear position on migrant strategy.

Potential implications:

Limited information for now on the magnitude of future changes, but given past performance, a budget impact of 0.3-0.5% of GDP a year, cut in the tax wedge has helped restart employment but did not address the bigger structural challenge of low competitiveness.

Sinistra Italiana

Origins: A mixture of former PD, SEL and M5

Chief economic advisor: Stefano Fassina

Approval rating: Currently 3%, ADA expectation: 12% by election time together with Art1

Policy programme:

Spend €30 billion in three years to stimulate growth (1% of GDP increase in the deficit than what agreed between the EC and Italy), green new deal of €16 billion to boost employment with 45% of the budget just for the South; VAT reduction to 24% to those workers with a VAT registration number; €3 billion on education for switching contracts from temporary to permanent for teachers

Articolo 1 (MdP – Art1)

Founders: Scotto, Bersani, Speranza, Rossi

Chief economic advisor: not visible currently

Approval rating: 6%, ADA expectation together with SI could reach 12%

Rising public investment, unlocking the public employment freeze, adjusting the Jobs Act and fighting the relocation of companies abroad and tax evasion of large digital companies

Political structure

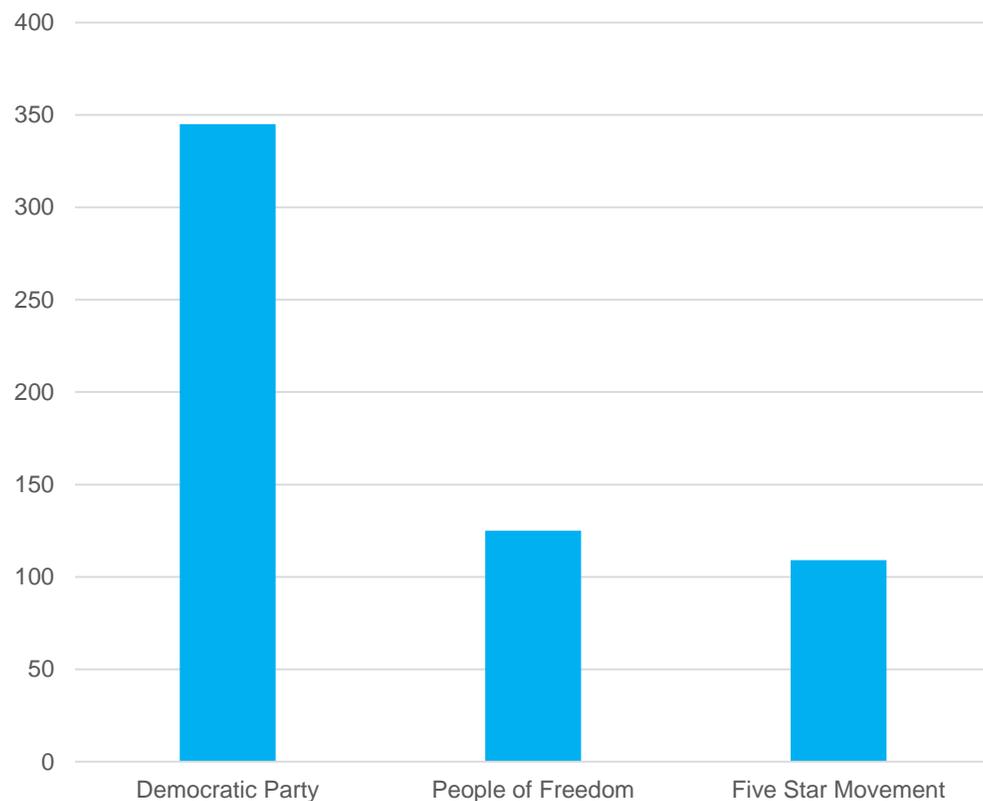President of the Republic: Sergio Mattarella

Prime Minister: Paolo Gentiloni
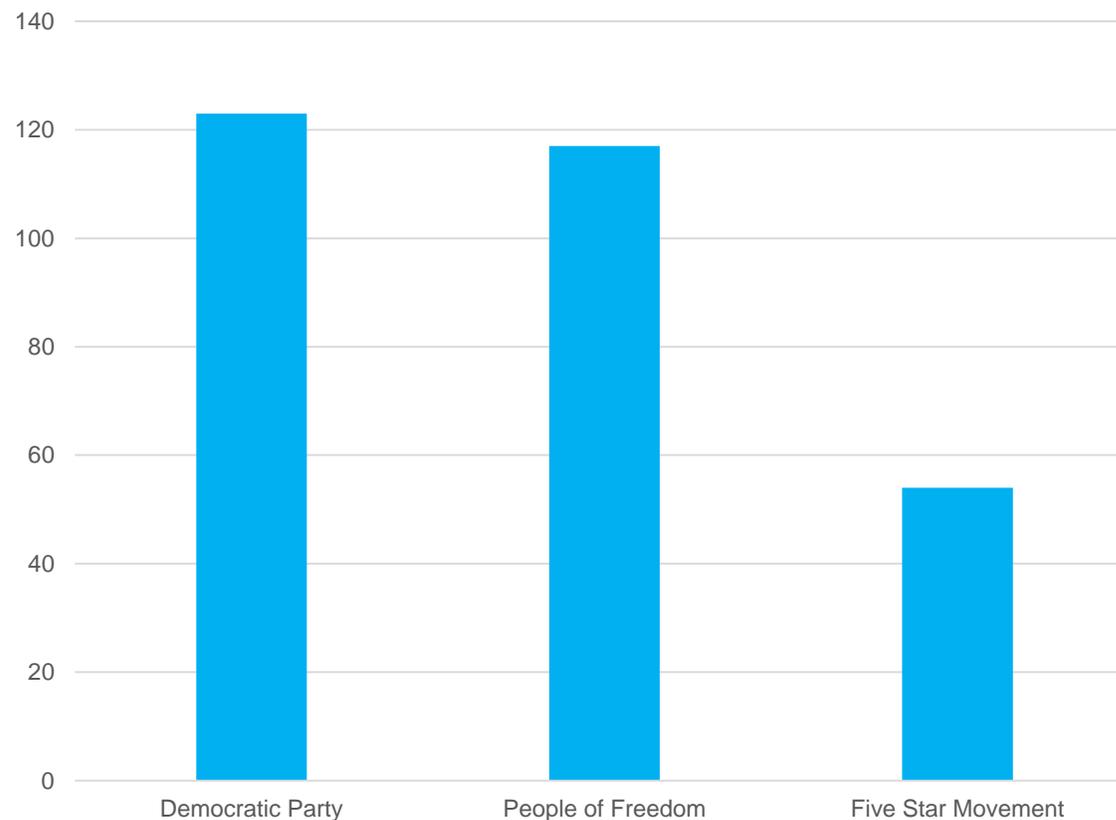
President of Senate: Pietro Grasso

President of House of Deputies: Laura Boldrini

Latest election result

2013 Election, Chamber of Deputies

2013 Election, Senate of the Republic

Sources: CEIC, ADA Economics

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Support for the EU and the euro

Eurobarometer: against the euro, %
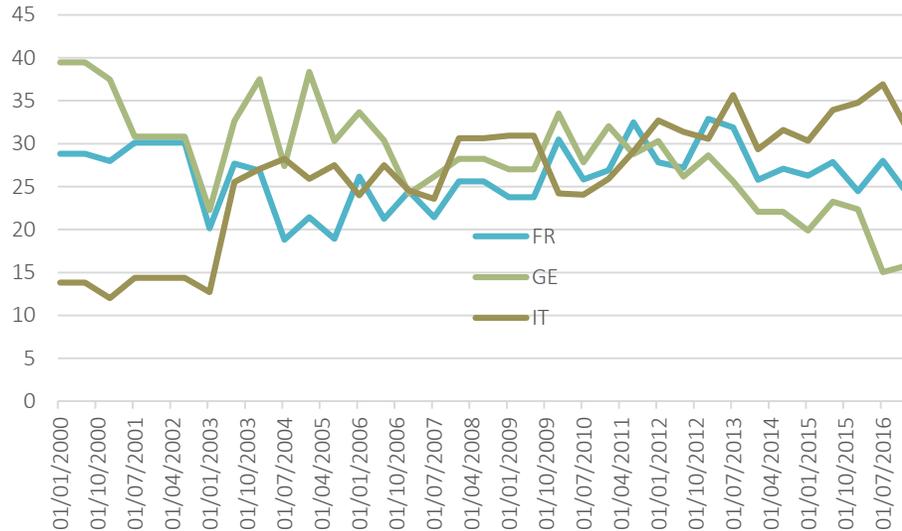
▪Our surveys show high disappointment of Italians and French in the EU, but a very small fraction *actually against the euro to the point of voting in favour of a currency change in a hypothetical referendum* – in fact we polled only 12% in France and 2%* in Italy ready/eager to do so. In Germany support for the EU is more widespread: 40% saying it is definitely a positive influence on their lives and 40% torn between positive and negative. However, there is also a high share of those that <u>regret</u> the DM: 30%!

Sources: Macrobond, ADA Economics

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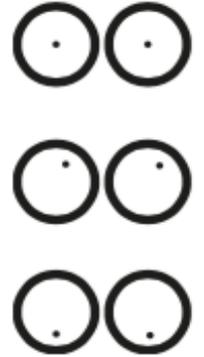
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